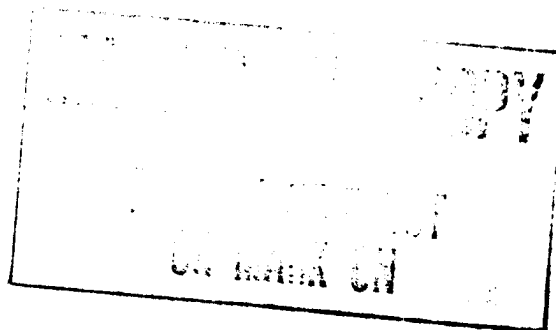




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# **Israel: Structural Economic Inefficiency**

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**An Intelligence Assessment**

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*NESA 84-10203  
June 1984*

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# **Israel: Structural Economic Inefficiency**

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**An Intelligence Assessment**

This paper was prepared by [redacted]  
[redacted] Office of Near Eastern and South Asian  
Analysis. It was coordinated with the Directorate  
of Operations. [redacted]

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Comments and queries are welcome and may be  
directed to the Chief, Arab-Israeli Division, NESA,  
[redacted]

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June 1984*

**Israel: Structural  
Economic Inefficiency**

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**Key Judgments**

*Information available  
as of 25 May 1984  
was used in this report.*

For almost a decade Israeli politicians have failed to address Israel's persistent economic problems—high inflation, low investment, large real wage gains, sluggish productivity, and large external deficits on civilian goods and services. Underlying many of these problems are laws, institutional practices, and traditions that inhibit the efficient functioning of the Israeli economy. Many of these obstacles are an outgrowth of the egalitarian ethic of the country's founders.

Israel's structural economic problems include:

- A powerful labor union organization, the Histadrut, that consistently wins large real wage gains.
- An indexation system that protects most Israelis from rapid inflation but reduces the government's incentives to attack the price spiral.
- An unwillingness to tolerate significant unemployment.
- An inability of government to prioritize expenditures or to enforce spending ceilings.

Most financial assets, such as savings accounts and government bonds, are linked to increases in the consumer price index. Many potential entrepreneurs prefer to put their funds into those assets, which guarantee a positive real rate of return. The payoff on plant and equipment investment, on the other hand, is by no means assured. Failure to invest in capital goods has been a major contributing factor to sluggish productivity.

Israeli governments understand the problem but have repeatedly backed away from remedial steps in order to protect precarious parliamentary majorities. Prime Minister Shamir and Finance Minister Cohen-Orgad have publicly supported tough measures that would have dealt with some of Israel's economic problems. Cohen-Orgad's program, however, failed to receive the necessary support from his Cabinet colleagues and Histadrut officials. The decision to hold elections on 23 July has ended any chance he might have had to implement an austerity policy.

As a result, we foresee growing balance-of-payments problems over the next few years. If current trends were to continue, we project that real GNP would grow at an annual average rate of nearly 4 percent in 1985-87, and the unemployment rate would drop to 4 percent in 1987. This would be at the expense of a growing civilian goods and services deficit that could nearly deplete foreign exchange reserves by 1987.

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Whatever government takes office after the election will face the same economic and political dilemmas that plague the current one. Coalition politics will probably continue to hamstring the adoption of adequate austerity measures. Only a dangerous shrinking of foreign exchange reserves is likely to force action by a coalition government.

Unlike the past when foreign capital inflows financed the growing external deficits, we expect traditional sources of financing to increase little if any. To stave off a foreign exchange crunch, the next Israeli government will first try the same approach as past governments—ask the United States for more aid. In addition, it may also ask for a rescheduling of debt owed to the US Government. Israeli officials believe that their “special” relationship with Washington precludes their having to turn to the IMF and knuckle under to the austerity and restructuring measures that that organization would require.

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## Israel: Structural Economic Inefficiency

For almost a decade Israeli politicians have failed to address Israel's persistent economic problems—high inflation, low investment, large real wage gains, sluggish productivity, and large external deficits on civilian goods and services. The Israeli public has become much more consumer-oriented during this period, in our view, and has come to expect an ever-increasing standard of living—expectations government officials are loath to disappoint. As a result, the primary focus of Israeli economic policy has been the maximization of consumer welfare. We believe the government to be elected on 23 July will seriously address the country's economic problems only if it wins an absolute majority or faces a serious foreign exchange shortage. [ ]

We believe that the sacrifices required of Israelis for the survival of the state have given them an ingrained conviction that the state owes them a "good life" materially. All Israelis except the ultraorthodox and Arabs are required to serve in the military, and men remain in reserve status—requiring at least 30 days of active duty a year—until the age of 55. Almost every family has been touched by death or serious injury during one of the five wars since the founding of the state. [ ]

### Structural Problems

A number of laws, institutional practices, and traditions inhibit the efficient functioning of the Israeli economy. Many of them stem from the egalitarian ethic of the country's founders. We believe that any Israeli government that wants to redress the country's economic problems will have to tackle these practices and the powerful vested interests that perpetuate them. [ ]

**The Histadrut.** No Israeli government, in our view, can hope to solve the country's economic ills without the cooperation of the powerful Histadrut labor union organization, which represents virtually all Israeli workers. Founded in 1920, the Histadrut is not only an umbrella organization for 43 trade unions, it is also

the largest employer in Israel. Hevrat Ovdim, the division of the Histadrut that owns commercial enterprises, was established in 1924 to provide jobs for immigrants. It also represented the fulfillment of the socialist ideology of the Histadrut's founders that agriculture and industry should be owned by workers. [ ]

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Histadrut affiliates employ one in four Israeli workers, produce 90 percent of the country's agricultural products and 25 percent of the manufactured goods, and control 85 percent of domestic transportation. According to a former officer in the US Embassy, managers of Histadrut-owned firms are instructed to operate in the most efficient manner and to adhere to the same labor relations and wage agreements that Histadrut officials negotiate with the Manufacturers' Association, the umbrella organization of private firms. [ ]

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The Histadrut has been able to dominate wage negotiations, winning large real wage gains and other benefits for its members. Its bargaining strength stems, in our view, from a traditionally tight labor market—the average unemployment rate since 1968 has been 3.7 percent—and membership that comprises 90 percent of Israel's labor force. As a result of Histadrut efforts, real wages have increased at an annual rate of 7.3 percent since 1975. [ ]

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The Histadrut has always been the power base of the Labor Party. Its economic enterprises provided funds for the party organization and jobs for loyal members. In return, Labor governments protected the interests of the Histadrut in a symbiotic relationship that ended with the election victory in 1977 of Menachem Begin's Likud bloc and the installation of the first nonsocialist government in Israel's history. [ ]

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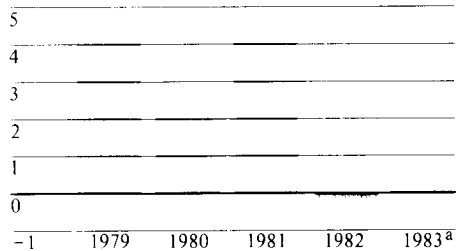
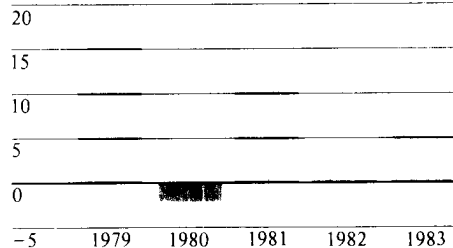
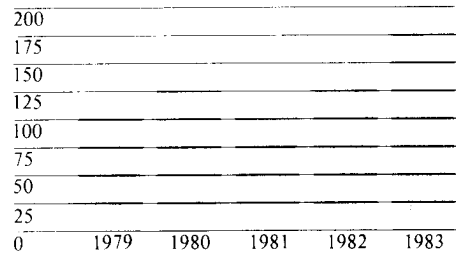
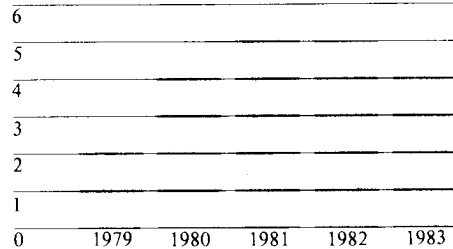
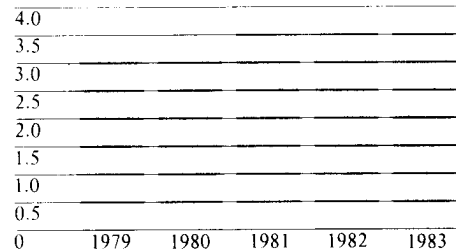
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**Israel: Economic Indicators, 1979-83**

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Note change in scales

**Real GNP Growth**  
Percent**Real Wages Growth**  
Percent**Consumer Price Growth**  
Percent**Unemployment Rate**  
Percent**Foreign Exchange Reserves**  
Billion US \$<sup>a</sup> Preliminary Israeli Government estimate.

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**Indexation.** Most Israelis are insulated against the ravages of rapid price hikes by a pervasive indexation system. Indexing, however, feeds inflation and reduces pressures on the government to attack the price spiral. Wages are indexed at 80 to 90 percent of the increase in the consumer price index (CPI), depending on the inflation rate. Any time the CPI rises 12 percent or more in a single month, wages will be adjusted. Wages will also be adjusted whenever price increases since the last adjustment reach 12 percent. Pensions and welfare payments are fully linked to the CPI, with adjustments made quarterly. Tax brackets are adjusted quarterly by 100 percent of the consumer price rise. [ ]

Most financial assets are also indexed. The principal on long-term savings accounts is fully linked to the CPI, and Israelis earn positive real rates of return averaging 3 percent. The US Embassy reports that banks have developed schemes that link savings with the CPI, foreign currencies, or some combination; in some cases, savers can wait until the maturity date to choose the indexing formula that provides the highest return. Government-issued bonds are indexed at either 80 percent or 100 percent and also have a real rate of return of about 3 percent. [ ]

**Interrelated Wage Agreements.** So that no group of workers obtains an "unfair" salary advantage over others, Israel's wage patterns are based on a series of interrelated agreements. For example, engineers' salaries are directly linked to those of the teachers, and technicians' pay is linked to that of the engineers. With the success the doctors had last year in winning a 60-percent pay hike, a number of groups, including lawyers and nurses, are now trying to link their wages to those of the doctors, according to press reports. Such linkages make it extremely difficult to encourage Israelis to enter occupations that are short of workers by increasing salaries for those jobs. [ ]

**Unemployment Is Anathema.** Israeli officials have repeatedly said that significant unemployment is not acceptable in Israel. In addition to the normal reluctance to incur the political costs of high unemployment, Israeli politicians have publicly affirmed their moral obligation to provide jobs for foreign Jews taking up permanent residence in Israel. Moreover, officials believe that retaining highly skilled Israelis

and attracting similar newcomers are vital to the country's economic and security interests. They fear that rising unemployment would generate major emigration, which, according to reporting from the US Embassy, is virtually unthinkable for a country built on the ingathering of Jews from abroad. [ ]

Traditionally, Israeli officials have said publicly and told US officials privately that, politically, they could not let the unemployment rate get much above 5 percent. In recent months, Finance Minister Cohen-Orgad has publicly stated that the rate may have to rise to 7 percent to deal with Israel's economic problems. Long before the unemployment rate reaches 7 percent, however, we believe that whatever government is then in power would face irresistible pressure to undertake expansionary economic policies to bring the rate back down. [ ]

**Lack of Monetary Tools.** Monetary policies are severely restrained by the Bank of Israel's lack of control over the money supply. Israeli law requires the Bank to print enough shekels to finance the government's budget deficit. Most Israelis, moreover, hold a variety of financial assets such as stocks and bonds, many of them indexed, that are considered to be as liquid as demand deposits, according to reporting from the US Embassy, and their appreciation is tantamount to an expansion of the money supply. The Bank has little control over these assets. Bank of Israel officials have resorted to selective credit controls—their only means of curbing the growth of the money supply—but bankers and companies have devised ways to get around them. [ ]

**Fiscal Chaos.** Most Israeli officials probably see little room to cut government spending. Defense, which currently accounts for 32 percent of the budget, has been considered sacrosanct because security is the government's first priority. Another 25 percent of spending is for legally mandated debt servicing and cannot be cut. Thus, budget cuts would have to be concentrated in the 43 percent earmarked for social services and religious activities. Such cuts run counter to the government's second priority—providing for an

egalitarian society—and have been opposed by smaller coalition parties whose support has historically been necessary for any government to remain in power [redacted]

The last several budgets have called for cuts, but these cuts never materialized. There is no administrative system to enforce spending ceilings. As a result, ministers have become adept at using “unanticipated” price rises to justify the spending of their ministries. No minister has ever been reprimanded by his colleagues for overspending, probably because they also are culpable. [redacted]

Attempts to increase revenues are usually counterproductive. Israel’s tax system is very progressive; an average income earner is in the 60-percent tax bracket. We believe the recent introduction of a 66-percent bracket will only add to tax evasion, which US Embassy and press reports indicate is a serious problem. Lax enforcement contributes to the tax-evasion problem. Efforts to reduce demand by boosting the value-added tax, purchase taxes, or fees are offset by the indexation system because they are included in the price of goods and services when calculating the CPI. [redacted]

### Resulting Economic Problems

Like predecessor governments, the Begin government never came to grips with these structural inefficiencies. Attention was focused instead on foreign policy and security matters. Although Prime Minister Shamir took the unprecedented step of creating the job of economic adviser in the Prime Minister’s office, his government has lacked the political strength to deal with the underlying causes of the country’s economic problems. As a result, the economy continues to be plagued by inadequate investment, lagging productivity, and a perennial civilian goods and services imbalance. [redacted]

Because most financial assets are linked to increases in the CPI, we believe many potential entrepreneurs put their funds into those assets that guarantee positive real rates of return rather than into plant and equipment investment with a payoff that is by no means assured. According to Israeli statistics, plant and equipment investment has grown 1 percent annually over the last decade, and its share of GNP has

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### Exchange Rate Policy

*During most of the past decade, Israeli officials have allowed the value of Israel’s currency to decline in relation to the US dollar and other currencies to help keep Israeli goods competitive in world markets. Until October 1977 government officials periodically devalued the currency (at that time the Israeli pound) to reflect the difference between Israel’s inflation rate and trading partners’ price rises. With the elimination of foreign currency controls in October 1977, the government has, for the most part, allowed a “dirty” float—the exchange rate has moved on a daily basis with only short-term intervention by the Bank of Israel to smooth the impact of irregular capital flows.*

*For almost a year beginning in the fall of 1982, however, the depreciation rate of the shekel was deliberately slowed by former Finance Minister Aridor in an effort to cut the inflation rate by making imports cheaper in shekel terms than they otherwise would have been. This reduced the competitiveness of Israeli exports, however, at a time when the global recession was already decreasing the demand for Israeli goods. Aridor’s shekel policy contributed to the increase in the trade deficit in each of the past two years. Finance Minister Cohen-Orgad has returned to the traditional exchange rate policy in order to improve the country’s balance-of-payments position.*

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declined from 21 percent to 17 percent since 1973. [redacted]

The poor investment performance has been a major factor contributing to sluggish productivity, which has grown only 1.2 percent annually since 1972. Other factors include:

- Hesitancy of Israeli employers to lay off workers for fear of being caught short when demand strengthens.
- High marginal tax rates that reduce worker incentives. [redacted]

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**Table 1**  
**Israel: Balance of Payments**

	1979	1980	1981	1982	1983 <sup>a</sup>
Civilian goods and services balance	-2,504	-2,121	-2,169	-3,200	-4,200
Exports	8,030	9,791	10,439	10,165	10,000
Goods	4,759	5,798	5,903	5,573	5,424
Services	3,271	3,993	4,536	4,592	4,576
Imports	-10,534	-11,912	-12,608	-13,365	-14,200
Goods	-6,769	-7,326	-7,250	-7,352	-8,273
Services	-3,765	-4,586	-5,358	-6,013	-5,927
Self-financed military imports	-250	-250	424	-174	-275
US military assistance	1,170	1,768	1,907	2,121	1,000
Military import payments	-1,420	-2,018	-1,483	-2,295	-1,275
Debt repayment (medium and long term)	-839	-957	-1,119	-1,053	-970
Financial gap	-3,593	-3,328	-2,864	-4,427	-5,445
Sources of financing	4,031	3,616	3,009	4,770	5,257
Unilateral transfers	1,400	1,474	1,584	1,422	1,296
US economic assistance	980	785	785	785	1,499 <sup>b</sup>
Israeli bonds	414	450	518	557	464
Other capital including short-term borrowing	1,186	900	85	1,962	1,498
Net direct investment	51	7	37	44	500
Change in reserves	438	288	145	343	-188

<sup>a</sup> Estimated.

<sup>b</sup> All of the \$910 million in economic aid for FY 1984 was disbursed on 30 December 1983.

Triple-digit inflation has bred a preoccupation with immediate gratification and individual interests. Numerous stories have appeared in the press depicting Israelis neglecting their work while they phone their brokers and pore over the financial pages of the newspapers to juggle their portfolios. The US Embassy reports that the general public is spending an increasing amount of time educating itself in how best to hedge against inflation. As price hikes have accelerated, this factor has played an increasingly important role in Israel's sluggish productivity performance, in our judgment. [REDACTED]

Lagging productivity and a strong appetite for imported consumer goods have undercut efforts to improve the goods and services imbalance. This deficit has doubled from \$2.1 billion in 1980 to an estimated

\$4.2 billion last year. Press reports indicate that Israelis have been buying video cassette recorders, which must be imported because there are no domestic production facilities, in such large volumes that Israel now has more of them per capita than any other country in the world. Real wage gains, combined with sluggish productivity, increase the costs of Israeli exports, reducing their competitiveness abroad. [REDACTED]

#### **Shamir and Cohen-Orgad: The Rhetoric Is on the Right Track**

Prime Minister Shamir was forced to deal with economic issues immediately upon taking office in October. The Tel Aviv Stock Exchange had crashed

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because Israelis were selling their stocks, particularly bank stocks, to purchase US dollars. In a speech to the Knesset when his Cabinet was approved, Shamir said that the government would reduce public and private consumption, cut subsidies, and raise labor productivity. He warned Israelis that the standard of living would not improve until production increased. After an all-night Cabinet session immediately following its approval by the Knesset, the new Shamir government announced an 18.6-percent devaluation of the shekel and a 50-percent boost in the price of most government-controlled commodities, including bread and milk. [ ]

Then Finance Minister Yoram Aridor was forced to resign two days later amid the furor created when his plan to make the US dollar legal tender in Israel was reported in the Israeli press. Cohen-Orgad was appointed Finance Minister a week later. He had publicly supported many of the measures required to deal with Israel's economic problems and called for a decline in real wages of at least 10 percent, large budget cuts, and increases in fees for a wide range of public services after taking office. He has declared that improving the balance of payments is his first priority and that reducing inflation is secondary. [ ]

Using the CIA econometric model of Israel, we project that the civilian goods and services deficit this year would have been \$2.8 billion compared with \$4.2 billion in 1983 if Cohen-Orgad's policies had been fully implemented. This improvement in the balance of payments would have been at the expense of a decline in real GNP of 2.6 percent, and the unemployment rate would have been 5.7 percent compared with 4.5 percent in 1983. [ ]

In the more than six months since taking office, however, Shamir and Cohen-Orgad have been unable to put their plan into action. Cohen-Orgad has not received the support from his Cabinet colleagues and Histadrut officials that we believe is necessary to carry out such a program. The Cabinet on 22 January approved budget cuts of about 4 percent in real terms for FY 1984,<sup>1</sup> but only after Shamir threatened to resign, according to the US Embassy. A few days

<sup>1</sup> The Israeli fiscal year begins on 1 April. [ ]

later, the US Embassy reports, Cohen-Orgad was forced to make concessions to TAMI—a small party in the coalition with a low-income constituency—on increased social welfare spending in order to keep its support on a no-confidence vote. [ ]

The honeymoon between Cohen-Orgad and the Histadrut was short lived. When he took office, Cohen-Orgad and Histadrut officials said publicly that they were willing to discuss Israel's economic problems and to devise solutions. At the time, Histadrut officials told US Embassy officials that, although they would defend the cost-of-living adjustment system and real wage gains, they were willing to discuss other issues. Cohen-Orgad and the Histadrut agreed to set up committees that would also include representatives of the Manufacturers' Association to study ways to promote exports, restrict imports, and help firms with financial problems. [ ]

Despite the good start, the relationship quickly soured. We believe Cohen-Orgad's repeated public calls for a decline in real wages of at least 10 percent and large price hikes greatly diminished the Histadrut's enthusiasm for cooperation. The agreed-upon committees were never established, and Histadrut officials quickly rejected the idea of a "package deal" on wages, prices, and taxes that the Cabinet on 1 January authorized Cohen-Orgad to negotiate. Histadrut officials believe their differences with the government are too great to be overcome. They accuse the government of trying to put the burden of economic retrenchment on wage earners, pensioners, and those on fixed incomes, according to reporting from the US Embassy. [ ]

The one major policy change Cohen-Orgad has carried out will be ineffective, in our view. Foreign currency controls were instituted in early November and have since been tightened. Israelis traveling abroad can purchase no more than \$2,000 worth of foreign currency; holdings of foreign securities, bank accounts abroad, and gold are prohibited; and a limit of \$2,000 on charges made abroad has been imposed on credit card holders. We believe that this policy

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**Table 2**  
**Israel: Alternative Economic Scenarios**

	Real GNP Growth (percent change)				Unemployment Rate (percent)				Financial Gap (billion US \$)			
	1984	1985	1986	1987	1984	1985	1986	1987	1984	1985	1986	1987
Current trends	1.9	2.8	3.6	4.9	5.2	5.0	4.6	4.0	6.4	6.7	7.3	7.9
Cohen-Orgad's policy	-2.6	0.1	1.8	2.8	5.7	6.6	7.1	7.3	4.7	4.5	4.3	3.7
Higher investment	1.9	4.6	5.8	8.0	5.2	4.8	3.8	2.4	6.4	7.3	8.3	9.0
Higher labor productivity	1.9	4.0	5.9	8.7	5.2	5.0	4.6	4.0	6.4	6.8	7.3	7.8
Austerity	1.9	0.3	0.8	1.4	5.2	5.3	5.6	6.1	6.4	5.7	5.0	4.3

does not address the causes of Israel's foreign payments problems and will have only a marginal impact at best because Israelis became adept at getting around such controls, which existed until October 1977. A black market in foreign currency reemerged in late April, which we believe is the result of efforts by Israelis to evade the controls. [ ]

The decision to hold elections on 23 July has ended any chance that Cohen-Orgad might have had to implement an austerity policy, in our view. US Embassy sources in the Finance Ministry report that Cohen-Orgad is under great pressure from his Cabinet colleagues to engage in "election economics." In what we believe is a move in this direction, the government in early May announced a smaller than usual monthly price rise of 9 percent on government-controlled items, such as milk, bread, and gasoline. We believe Cohen-Orgad will try to avoid blatant manipulation of the economy prior to 23 July, but he probably will succumb to pressure to hold the line on prices and to look the other way as ministers exceed their spending ceilings. [ ]

#### After the Election

Whatever government takes office, it will face the same economic dilemmas that plague the current one. If current economic trends were to continue, we project, using the CIA econometric model, that private consumption would grow at an annual average of

6.6 percent in 1985-87,<sup>2</sup> helping to produce GNP growth averaging nearly 4 percent. The unemployment rate would drop to 4 percent in 1987. Even though recovery in Western Europe and the United States would boost exports by an annual rate of 7 percent, continued strong domestic demand would increase imports, resulting in a civilian goods and services deficit of \$5.3 billion in 1987 compared with \$4.2 billion last year. The financial gap<sup>3</sup> would reach \$7.9 billion in 1987 compared with \$5.4 billion last year. [ ]

We used the CIA econometric model to project what would happen in several alternative scenarios that assume that the new government tries to deal with some of Israel's economic problems. A program to increase labor productivity by lowering tax rates, for example, would stimulate the economy. Real GNP would increase at an average annual rate of 6.2 percent. Although higher domestic demand would boost imports, much of the additional output would be available for exports, and the financial gap would not change much from our present projections. [ ]

<sup>2</sup> Because forecasts become more tenuous the further into the future they go, we limited the model to forecasts for the next three years. [ ]

<sup>3</sup> The financial gap is the sum of the civilian goods and services deficit, self-financed military payments, and debt repayment. [ ]

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If the new government tried to boost investment—through low-interest loans, rapid depreciation allowances, or lower income tax rates, for example—the domestic economic benefits would be substantial. Using the CIA econometric model and assuming real investment increases 10 percent annually in 1985-87, we project that GNP would grow by an average annual rate of 6.1 percent, 2 percentage points higher than current trends would indicate. By 1987 the unemployment rate would decline to 2.4 percent. The financial gap, however, would increase to \$9 billion in 1987, \$1.1 billion more than would be the case if present trends continue, in part because much of the additional machinery and equipment would have to be purchased abroad. [REDACTED]

If, under an austerity program, real private consumption and government civilian and domestic military consumption declined 2 percent annually in 1985-87 and real exports increased by 10 percent annually, the financial gap in 1987 would be \$3.6 billion less than if current trends continue, but it would still remain at \$4.3 billion. The cost would include a drop in real GNP growth to an average of less than 1 percent annually and an unemployment rate of 6.1 percent in 1987. [REDACTED]

Unlike the past when foreign capital inflows financed the growing financial gap, we expect traditional sources of financing, such as unilateral transfers, Israeli bond sales, and commercial bank lending, to increase by only small amounts, if at all. Transfers have declined in each of the past two years, and Israeli bond sales fell last year. [REDACTED]

[REDACTED] Although the level of concern varies among bankers, they appear to be worried about persistent triple-digit inflation, the growing trade deficit, and the possibility of a future debt rescheduling. The Israelis could try to avert a decline in foreign exchange reserves by accelerating the depreciation rate of the shekel, but such a move would be at the expense of even higher inflation. [REDACTED]

#### **Outlook**

Before an austerity program could work, the new government would have to muster the political will to implement and sustain it. A program would also

require an agreement with the Histadrut to reduce real wages. If either Labor or Likud wins a majority in the Knesset, we believe an austerity policy might be in place relatively soon. A strong Likud victory would give Cohen-Orgad the political strength to carry out the policies he has been advocating. Even Labor Party officials have been calling for budget cuts, and a Labor-led government would have an advantage in reaching an agreement with the Histadrut because of their close ties. [REDACTED]

If neither the Labor Party nor the Likud bloc wins a majority and a coalition government emerges after 23 July, it will be extremely difficult for the new government to agree on austerity measures. A coalition government forced to rely on the continuing support of TAMI or the religious parties to stay in power, for example, will find it almost impossible to pare social or religious programs. Nothing short of a drastic shrinking of foreign exchange reserves could force the hand of a coalition government, in our view. [REDACTED]

#### **Implications for the United States**

To stave off a foreign exchange crunch, we believe the next Israeli government will take the same approach as past governments—turn to the United States for more aid. Israeli officials will take the position that additional aid should be grants rather than loans, citing the US administration's recommendation for aid to Israel in FY 1985, which is entirely grant, as a precedent. In addition, the Israeli Government may also ask for a rescheduling of debt owed to the US Government. This debt is almost half of the \$22.5 billion outstanding at the end of 1983. Principal repayment on Foreign Military Sales loans will begin to increase in 1986 when the 10-year grace periods start to lapse. [REDACTED]

Israeli officials believe that their "special" relationship with Washington precludes their having to turn to the IMF, which they are extremely reluctant to do because of the austerity policies the IMF would advocate. Moreover, some Israeli officials appear to believe that Saudi Arabia has disproportionate influence within the IMF and are loath to accept what they would regard as Saudi dictation. [REDACTED]

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The Israeli Government may try to persuade Jews living abroad, particularly those in the United States, to increase their contributions to Israel. These contributions, however, have not responded to economic crises in the past. According to Israeli statistics, donations soared in 1974 after the October 1973 war but fell back to traditional levels in 1975 and 1976 when Israel was in a severe foreign exchange crunch. Moreover, the response to the Israeli invasion of Lebanon suggests that foreign Jews may only increase their contributions when the survival of the state is at stake. The increase in financial support from abroad in 1982 that Israeli officials hoped for did not materialize. For the first time since 1976, unilateral transfers actually declined. [REDACTED]

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Economic considerations will have little impact, however, on Israeli policies on such issues as West Bank settlements and the military's stay in Lebanon. We believe that outlays for these activities are a relatively small share, less than 5 percent, of the government's budget. Israeli perceptions of their security interests rather than financial considerations will be the primary determinant of their strategy. [REDACTED]

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